Uncertainty is the enemy – SA downgraded to "junk status"

A lot has been said in the media over the last few weeks regarding the possibility of whether South Africa (SA) would be downgraded to "junk status" by Moody's and thereby be forced to exit the FTSE World Government Bond Index (WGBI). Emphasis was placed on the implications for our stumbling economy, the government, corporates, consumers and what the government is required to do in order to avoid a possible downgrade. On Friday night, 27 March 2020, Moody's finally downgraded SA to "junk status", bringing it in line with peer rating agencies S&P and Fitch. The downgrade by Moody's does not come as a surprise as they have been lenient with us, but the timing is not ideal as we are fighting a global pandemic in the coronavirus. The key reasons for the downgrade are structurally weak economic growth; constrained capacity from a government perspective to stimulate the economy; and the exponential rise in government debt. For the remainder of this article, we will touch on what a sovereign credit rating is, what "junk status" means, and then take stock of the implications for clients going forward.

What is a sovereign credit rating?

A sovereign credit rating expresses an opinion regarding the ability of a country to meet its financial commitments. The respective rating agencies utilise various measures that allow them to gauge a country's social, economic and political position in order to determine the probability of a country defaulting on its repayments. To explain this, let's assume that the rating agencies are banks and that they are lending money to SA. Given that governments do not typically default on their debt as they can increase taxes for SA residents to cover the increase in costs.

What does "junk status" mean for SA and its citizens?

The bottom line is that it will cost our government more to borrow money from the market. Fortunately, most of our government debt is denominated in rand, making up 90%, with the rest in foreign currency. Currently, government spends close to R229 billion in interest payments with our total debt amounting to R3 trillion. This impact will also be felt by SA consumers, who are highly indebted and continue to finance their lifestyles through debt. Their cost of servicing this debt will become more expensive. The sad reality is that this comes at a difficult time, given the coronavirus and the potential impact on businesses and consumers. We could see retrenchments, higher taxes and government could be forced to spend less on social programmes to cover the increase in their interest payments.

What has happened in the meantime?

For the 2020 calendar year so far, foreigners have been net sellers of R48 billion worth of SA government bonds. The past few weeks leading up to the review by Moody's have been volatile, with the SA 10-year government bond trading at a yield of 12.36% in comparison to it trading at a yield of 9.12% at the end of February 2020. This spike in yield implies a capital loss over the shorter term, which was caused by foreign and local investors selling our government bonds, whereby there were willing buyers but not to the same extent as those who wanted to sell our government bonds. The South African Reserve Bank (SARB) stepped in, buying our government bonds and easing fears for market participants. Following the downgrade by Moody's, we saw the rand trade at R18 to the US dollar and government bonds rallying (yields coming down).

The market's reaction to the downgrade was strange as one would've expected our bonds to sell-off and yields to spike. There are two factors which could explain this. Firstly, foreign institutional managers that have investment grade bond mandates have already sold some of their SA government bond exposure; and secondly, there is a reprieve from FTSE Russel, which administers the WGBI, whereby they stated that the rebalance from SA being removed from the WGBI will only take place at the end of April 2020. The quantum of the outflow from SA being removed from the WGBI is estimated to be between $1 billion and $12 billion. Most market commentators are unsure about the exact amount and whether the selling will happen over the course of this month or at the rebalance at the end of the month. The expectation is that the SARB will step in once again and absorb most of the foreign selling.

As expected, we have also seen our big five local banks being downgraded as they cannot have a higher credit rating than the sovereign rating. Moody's has downgraded the respective banks in line with the sovereign. However, Fitch has downgraded them to one notch below the sovereign at this point in time.

Going forward…

We have always communicated to clients to stay the course despite the various obstacles they may have encountered. This is because it is difficult to time the market and risky assets are still expected to outperform over the longer term. If one looks at the return of SA cash, bonds and equity over the past one year, three years, five years, seven years and 10 years as at 31 March 2020, SA cash and bonds have outperformed SA equity over all periods except over the past 10 years. One needs to understand that this has been after the current sell-off and speaks to the long-term performance of growth assets.

We must acknowledge that the SA economy was under pressure before the coronavirus, but this pandemic coupled with the global sell-off has brought SA's problems forward to the present. However, I don't think we can look at these returns and expect this to continue indefinitely. This does mean that the government is forced to work together to get SA moving forward, which could be an opportunity to cull some of the poor performing state-owned enterprises and

implement much needed structural reforms as there is a risk of further downgrades if we do not address the concerns raised by the ratings agencies. The SARB has an important role to play as well, with the expectation that they can cut interest rates further, thereby providing relief for consumers.

In every crisis, an opportunity presents itself. This opportunity could be buying SA government bonds at these attractive levels, thereby locking in very attractive long-term returns. For those foreign investors who prefer higher yields, SA government bonds present a compelling option in a world of negative yielding government bonds (Germany, France and Japan) and a 0.605% yield on the US 10-year government bond.

References:

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- Business Day
- Laurium Capital
- Obsidian Capital
- South African National Treasury

Glacier Financial Solutions (Pty) Ltd.

A member of the Sanlam Group
Private Bag X5 | Tyger Valley 7536 | Email client.services@glacier.co.za | Tel +27 21 917 9002 / 0860 452 364 | Fax +27 21 947 9210 | Web www.glacier.co.za | Reg No 1999/025360/07
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Private Bag X8 | Tyger Valley 7536 | Tel +27 21 950 2600 | Fax +27 21 950 2126 | Web www.smmi.com *|*Reg No 2002/030939/07
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